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C O N F I D E N T I A L SECTION 01 OF 05 MOSCOW 001149

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SUBJECT: ENERGY DEPUTY SECRETARY SELL'S TRIP TO MOSCOW:
HYDROCARBON WRAP-UP

Classified By: Amb. William J. Burns. Reasons 1.4 (b/d).

11. (C) Summary. Deputy Secretary of Energy Clay Sell visited Moscow March 11 - 14 to participate in the bilateral Energy Working Group (EWG) and to meet with U.S. energy companies as well as Lukoil and Gazprom. At the EWG, there was a good exchange of views on information exchanges, energy efficiency, oil spill prevention, and each country's investment climate. The Deputy Secretary met with Lukoil's CEO Vagit Alekperov to discuss Lukoil's successful cooperation with ConocoPhillips, with Alekperov also raising Lukoil's projects in Iraq and Iran. Gazprom's Deputy CEO Alexander Medvedev waxed philosophical about the rectitude of the state's new role managing key sectors, Gazprom's efforts to diversify markets, the need for promoters of the "southern gas corridor" to include Russia in the game, and he criticized Shell's management of the Sakhalin 2 project. Energy Minister Khristenko proposed conducting a small, bilateral seminar to discuss each country's energy policies. Sell stressed the benefits of Russia's making a decision on its openness to foreign investment. Khristenko agreed that making such a decision soon is in the GOR's best interest and predicted passage of the Law on Strategic Sectors this year. End Summary.

ENERGY WORKING GROUP

12. (C) Sell co-chaired the EWG with his Russian counterpart Deputy Energy Minister Ivan Materov. Sell agreed with Materov that it had been too long since the two sides met (about two years) but that much good had happened in the intervening period. Sell pointed out, and Materov agreed, that the work of the group going forward should be based on the principles laid out at the St. Petersburg and Gleneagles G-8 Summits. On information exchanges, the U.S. side noted that DOE's general counsel had reviewed and commented on the protocol dealing with transmission of statistical data and analyses and that DOE had sent the comments to the Russian side and is waiting for the Ministry's reaction. Materov's colleagues noted that internal approval for over half of DOE/EIA's suggestions for exchange of facts and energy indicators had been approved but that the ministry is still reviewing the propriety of releasing a handful of the requested items. Materov agreed with Sell that information exchange is essential for clarity and functioning markets, observing that Russia has trouble forecasting oil market

movements, for example. Sell and Materov agreed to aim for a signing of the information exchange protocol by the end of 2007.

13. (C) The Russian side said that the bilateral work on energy efficiency is a natural follow-on to the G-8 Gleneagles commitments and the topic will get attention at the next summit in Germany. President Putin stressed energy efficiency and the ministry expects to finish drafting a law on energy savings in March. The GOR will also try to push legislation on renewables and other alternative sources of energy. Materov said that it was "critical to work with you" in writing laws and regulations in this sphere. Specifically, Russia is working on a federal program on energy consumption to 2015 that aims to reduce energy consumption per unit of GDP by nearly 40% from 2006 levels. The GOR also specifically hopes to implement a program similar to the U.S.' Federal Energy Management Program (FEMP) to reduce energy consumption in federally-funded governmental facilities. For these and other energy efficiency programs, Russia needs international technology and management expertise, needs to share experiences, and needs a dialogue to help shape its legislation and regulations in this sphere. Further, the Russian side indicated that they were pleased with the cooperation on oil spill prevention and that it should continue.

14. (C) Regarding investment climate issues, Alan Hegberg, Deputy Assistant Secretary for Policy and International Affairs, relayed to the Russian delegation the changes to the U.S.'s energy economy over the last thirty years, especially regarding deregulation of the gas and electricity industries. These changes are on-going and are market-based and rely on new innovations. The Russian side acknowledged Hegburg's arguments that success in building an energy economy requires

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long-term dedication, market-based incentives for competition, technological innovation, energy efficiency, self-sustaining investment, non-discriminatory opportunities, transparency and financial discipline, and integration into the world economy. Materov replied that the GOR was committed to the same approach, but needed to finally transform the Soviet-era legislative and regulatory base into a modern one. The current debate on a strategic sectors law was an example, drawn largely from U.S. experience, of Russia attempting to build that bridge to modernity.

15. (C) At the close, Sell mentioned that in an earlier meeting Energy Minister Viktor Khristenko had proposed the idea of a bilateral energy forum to debate/discuss each country's national energy strategy. Khristenko's idea was that he and Energy Secretary Bodman would open the meeting. Sell indicated that he would relay the message to Secretary Bodman, while Materov noted that "debates bring governments closer."

LUKOIL

16. (C) On March 12, Sell met with Lukoil CEO Vagit Alekperov who said that his company was looking at opportunities globally, including expansion in the U.S. Lukoil wants to complete the value chain of bringing West Siberian oil to U.S. consumers' gas tanks through its retail network in the U.S. Sell said that the ConocoPhillips (CP)-Lukoil partnership should serve as a model for future investment and that the U.S. is open to Russian investment. Alekperov agreed and pointed to the personnel exchange with CP and the fact that Lukoil is taking on some CP management techniques and senior managers as examples of increased cooperation. Lukoil is in extremely good shape financially as it has the largest reserves of any private company in Russia, plans to double production over the next decade to be as big as ExxonMobil by that measure, and it is the only company that has replace reserves for 15 years running. Lukoil plans to

invest around \$10 billion annually divided 70/30 upstream/downstream.

¶7. (C) Alekperov admitted the oil business in Russia is intensely political. The decision has been made that big fields -- both onshore and offshore -- should be developed by national companies (like Lukoil), not necessarily just state companies (i.e. Gazprom and Rosneft). He hopes Lukoil will be given this opportunity and that CP has success in its pursuit of Shtokman, an outcome that he believes could further his own attempts to strike a strategic alliance with Gazprom for offshore ventures. That said, Alekperov has doubts about the economics of Shtokman due to the field's difficulties. He admitted nonetheless that an element of capriciousness remains in the debate over access to large fields and that "different visions" are in play regarding what the rules should be. He said that Gazprom is not impossible to deal with since Gazprom usually admits its weakness once ensconced in a deal but when first negotiating Gazprom will always act as "older brother". Sell stressed the need to draw on the technical capability of international oil companies on an equity basis to develop challenging fields such as Shtokman.

¶8. (C) Regarding the strategic partnership with CP, Alekperov emphasized that it has the political support of not only the Kremlin leadership but society as a whole. He observed in the same vein that Lukoil is the only Russian company currently partnering successfully with almost all major U.S. oil companies, with USG agencies such as OPIC (the Vysotsk oil products terminal), with the EU (building a possible oil terminal at Wilhelmshaven in Germany), with the Caspian countries, and with many others. Lukoil is all about business, not politics, he emphasized, although he admitted that sometimes "crude oil smells a lot like politics".

¶9. (C) Alekperov made a strong pitch for his company to develop Iraq's West Qurna (WQ) field. Lukoil would need 30 months to launch the project from the date of signing. WQ could sustainably produce 500,000 b/d, production that would help develop the economy to stabilize the political situation and the new oil law should make this a possibility. Due to the work Lukoil has already done, should another company win

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the rights to the field it would take three times as long to develop WQ. Sell pointed out that we want to see a stable Iraq that is able to make responsible use of its natural resources. The case for Lukoil's involvement was compelling and, if the Iraqi chose to go that way, we would be supportive.

¶10. (C) Alekperov also sought Sell's reaction to Lukoil's work in the Anaran project in Iran. Alekperov said that Lukoil is a junior partner to Norsk Hydro, that the project is at the exploration stage, and that Lukoil has been compliant with U.S. sanctions and has kept its relationship with ConocoPhillips in mind when deciding on steps towards this project. Lukoil has clearly chosen not to pursue its work with Iran in a manner that would threaten its business interests in the U.S. market, even if complying with U.S. law would mean losing out on a lucrative opportunity in Iran. Lukoil can continue in its current holding pattern on Anaran for six to twelve months but after that there will be plenty of other firms, including perhaps Russian firms, willing to take on the Anaran project. Sell emphasized that a way forward with Iran is difficult for both countries.

¶11. (C) Sell stressed the importance of the government to move forward on the subsoil law to clarify the rules for foreign investment. Speaking expansively, Alekperov noted the tendency not just in Russia but throughout the world for resource-rich countries to adopt nationalist and protectionist measures in key sectors. He implicitly criticized these countries as typified by complacency born of wealth, highlighting Kazakhstan as one of the worst. In

Russia, at least there is a lot of diverse opinion, which is healthy since "if things had been decided quickly, everything would now be owned by Gazprom". He predicted that a better version of the subsoil legislation or amendments to the existing law would be produced by September and did not particularly see impending Duma elections this winter as an obstacle to passage. He reiterated how important the survival of private companies in the Russian energy sector is, noting that Gazprom and Rosneft are simply not capable of developing enough resources to keep Russia's oil and gas production steady. Alekperov closed by emphasizing that Lukoil will become more internationalized - Lukoil is too "outstanding" a company and with production that will one day exceed ExxonMobil's, Lukoil cannot be a "local" company.

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GAZPROM

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¶12. (C) Alexander Medvedev, head of Gazexport and Deputy CEO of Gazprom, covered a range of topics with Sell at a meeting on March 13. Regarding gas price disputes with FSU countries, Medvedev said that the Belarus spat had not been accompanied by nearly as much western objection as the Ukraine spat a year earlier, despite the last-minute deal with Belarus. Russia hopes it is clear to the world that Russia's policies towards all gas consumers are equivalent - to move to market based pricing. This includes its own internal customers now that the GOR has decided to increase domestic prices to netback parity by 2011 (except for 15 percent of the market occupied by households, which will be liberalized more slowly). The GOR and Gazprom are confident that this will benefit the Russian economy by introducing more energy-efficient technologies. Sell replied that U.S. experience with deregulation had resulted in at least two major outcomes - more efficient technologies throughout the economy and more sustainable investment.

¶13. (C) Medvedev said the Bovanenko field on the Yamal Peninsula would require \$40 billion to develop and that first production would be in 2011. This field will be developed concurrently with the Shtokman field. Chevron's recently signed deal with Gazprom Neft was a "good deal" and good project. Gazprom is impressed with ExxonMobil's management of Sakhalin-1, which despite cost increases for such projects around the world did not suffer anything like the exorbitant cost overruns of Sakhalin-2 or Snovhit. Gazprom is having other good experiences with U.S. companies these days, including with Aspen Technologies, which recently entered a deal with Gazprom's petrochemical subsidiary Sibur.

¶14. (C) Regarding Shtokman, Medvedev said that Gazprom

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intends to pick a maximum of three partners from the shortlist of five by May or possibly as late as June. Before, the valuation of Shtokman's reserves by the western firm had simply been too low, resulting in counter-offers by them that were insufficient. Over time, the discount rate associated with Russia will decrease, leading to higher valuations by the west so that asset-swaps may be revisited. But for now, he said, the foreign firms acknowledge that Gazprom will own the reserves and that they will have to find alternative "values to book" from the project.

¶15. (C) Waxing philosophical, Medvedev admitted that Russia has not had a long history of a consistent investment climate. The state, however, is "back where it should be", running the industries that are genuinely strategic in their importance. This is the only way to protect the people and the nation, as opposed to the 1990s when the nation's assets were handed out to a few individuals for much too low a price. And Russia is not as bad as some countries, having decided not to renationalize but rather to create a sort of "semi-private" sector. The next generation of Russians is "absolutely different" than the older generation but they still recognize the "historical mistake" of the 1990s and the

rectitude of the state regaining its rightful role in managing key sectors to avoid abusing the people's trust through botched privatizations. Even at Davos, which he attended with his namesake Deputy Prime Minister Dmitry Medvedev, notables had been commenting on the progress Russia had made in its legal structure, tax climate, registration rules, banking procedures, and so on. And the senior Medvedev had promised the Davos audience that the rules about access to strategic sectors would be passed soon, and people are taking him at his word. To Sell's question about what happens after the March 2008 elections, Medvedev predicted that whoever takes over will continue the policies under Putin. Putin achieved a great deal and people recognize that

¶16. (C) Gazprom is inefficient, he admitted, and needs much in the way of cost management and operational efficiency, problems that "will not be solved overnight". But with upside in this area, commodity price upside, and reserves upside, Gazprom expects to grow its market capitalization to \$1 trillion eventually, and Medvedev claims that objective analyses by western market analysts come in at around the same magnitude.

¶17. (C) Gazprom and Russia do not understand some U.S. policies, Medvedev said. Specifically alluding to the Nabucco pipeline and the southern gas corridor, he said it is a mistake to think such a corridor can be built without Russian gas. Without Russia, there is no gas, and without Russia's markets in Europe there is no market, he argued. Gazprom made an agreement with Greece and Turkey regarding onward transit of gas from the Blue Stream pipeline and the three will soon decide on the feasibility of such a Russia-origin corridor. Without Russia, the southern corridor "will fail, just as it is now frozen".

¶18. (C) Sell asked Medvedev why Gazprom wants to remain dependent on European markets rather than diversify markets, such as through LNG to North America. Medvedev replied that Russia is doomed to remain dependent on Europe but is also diversifying to North America and Asia. This is important to the world since China or India, for example, have unsustainable economies without resolution of their resource scarcities. Gazprom is basing all its moves on commercial rationale alone, "trying to avoid" politics in its decision-making.

¶19. (C) Medvedev, who had been the key negotiator in wrenching a 50% plus one share from the Sakhalin 2 consortium, had special scorn for Shell's management of the project. He repeated the distrust that stemmed from the unfortunate juxtaposition of the constructive deal Gazprom and Shell had struck in 2005 that was followed "the next day" by Shell's announcement of extreme cost overruns at Sakhalin

¶2. Noting that he had grown up on Sakhalin Island and knew environmental degradation there when he saw it, Medvedev offered the example of the Sakhalin 2 pipeline being built right through the middle of a national park when the federal license clearly said the pipeline must skirt the park's territory. True, he admitted, the regional government had

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given Shell permission to build it through the park, but "Shell is not from kindergarten" and knows better than to try and get away from such federal supervision by hiding behind local authorities who "have no right" to supersede federal power on such matters. Asked why on earth Gazprom wanted into such a project if it had so many problems, Medvedev responded that Gazprom bought in at a proper discount to adjust for such problems and that Deloitte and Touche had verified that the price paid was a fair valuation. With Shell, Gazprom is now embarking on a plan to overcome the ecological damage done by Sakhalin 2, he said.

KHRISTENKO

¶20. (C) In a lengthy private conversation with the Deputy Secretary and Ambassador, Minister of Industry and Energy

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Viktor Khristenko stressed the need to focus our energy relationship on practical results. Along those lines, Khristenko proposed "a joint seminar on national energy policies." The proposal was short on specifics but would be modeled on seminars that Russia has with the EU and Japan and would follow up on the principles laid out at the St. Petersburg G-8 Summit. The seminar could be a small gathering with Khristenko and Secretary Bodman, perhaps, opening the meeting. Khristenko envisioned high-level private sector participation from both sides. Sell said that this sounded like a good idea and that he would relay the message in Washington.

¶21. (C) Sell said that the G-8 principles were a good basis to build on. He encouraged Russia to move forward on building transparency in the energy sector, saying that it was Russia's choice to do what they want regarding restrictions on foreign investment but the key was making a prompt decision. Khristenko said that the sooner the GOR defines strategic sectors the better. He expects the Law on Foreign Restrictions to pass this year but would not be drawn out on the Subsoil Law. Sell continued that energy efficiency was an area our two governments could do some good work. Khristenko recognized this and noted that improving energy efficiency was one of the reasons the GOR decided to raise domestic gas prices to European netback levels by 2011. Khristenko noted that the planned ramp-up in Russia's civilian nuclear power is part of the long-term strategy to rationalize energy use.

¶22. (U) The Deputy Secretary's delegation has cleared this cable.
BURNS